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General Business Conditions

THE country has been flooded with comment on commodity prices and living costs during the past month, most of it deploring the present level and seeking to place blame in one quarter or another. Some commentators appear to believe that the situation is simple, namely, that sellers fix prices, that they are being unconscionable in their demands, and that if they can be made to see the light they can mark prices down and solve the cost of living problem. Others blame the high prices on the increases in wage rates, now started on another round, or on inefficiency of labor. Still others point to the influence of the expansion of the money supply and the low interest rate policy.

Some believe prices must go even higher because of the money supply, credit expansion, wage influences or world needs. Others fear the effort to talk prices down will be over-successful, disturbing confidence and causing a stoppage in buying, cancellations, losses and depression. Many think farm and food prices are the heart of the problem, but the most vocal critics center their attacks on prices of manufactured goods.

Since there are elements of truth or half-truth in most of these comments, the price situation is not simple, but complex. Proposals for a single or simple cure are not only illusory, but add to the confusion of thought. They even obscure the goal which business, labor and government should seek. What people now seem to desire and the Government pleads for is simply lower prices. Where the emphasis really belongs, however, is on balance in price, cost and income relationships and on stability in the price level.

Many think lower prices and balanced prices mean essentially the same thing, because it would be impracticable to bring prices into balance without marking many prices down. Nevertheless, the distinction should be preserved, for the policies adopted will not be appropriate and effective unless the goal is clearly seen. To make lower prices in themselves the objective is to invite an indiscriminate assault on the price level, perhaps by crude and dangerous methods which would hold the threat of unnecessary deflation and depression. To think that what is needed is to work out a new balance, on the other hand, is to invite a discriminating consideration of differences among prices and of factors influencing prices, and to establish policies and attitudes accordingly.

The Cause of the Price Rise

The primary cause of the price rise has been the tripling of the money supply, as a result of the wartime expansion of bank deposits and currency in circulation. This money was created mainly by government borrowing from banks. The goods for which it was spent in the first instance were largely destroyed, but after the borrowing ceased the money remained, while the supply of goods available was insufficient for buyers' wants. The pressure of money and wants

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forced prices to a new high level. A second main cause was the rise in wages and industrial costs. These and other contributing factors operated in the familiar spiral fashion, one man's prices representing another's costs, and so around the circle.

If all prices and incomes rose in the same degree no one would be priced out of the market, the exchange of goods and production could go forward, and the situation would excite no special apprehension. But as in all past inflations, the rise has been uneven. Some prices have lagged and the incomes of a good many groups of the population have lagged. Those who have lagged have lost purchasing power. In short, the balance has been disturbed. Some people cannot buy the products of other people.

Most of the difficulties of the current inflation are traceable to the unevenness of the rise from one price level to another. The problem now is to get prices and incomes into better relationships on some new level. It is safe to say that the new level will be substantially higher than in 1939, giving effect to money and wage factors. But it must also be expected that it will be below the present average level, for the prices which have risen the most – in this case farm prices – already have declined and in time are expected to drop further. Resistance to many other prices is marked. In any case, an effort to adjust all prices to the highest prices would be impracticable. It would cause further great distortions.

What Prices Are Too High?

People who hear it said that prices are too high should ask two questions: "What prices?" and "Too high in relation to what?" Wheat is four times its prewar price, but steel is up only 23 per cent. Food prices, according to the wholesale price index of the Bureau of Labor Statistics April 19, were 130 per cent above the 1939 average. This increase compares with a 132 per cent rise shown at the peak in 1920 over the 1913 average. Farm products as a whole on April 19 were 169 per cent above 1939; at the peak in 1920 they stood 138 per cent above 1913. All commodities other than farm products and foods were 63 per cent above 1939, while at the 1920 peak they were 144 per cent above 1913. In the later '20s food prices stabilized at about 56 per cent above 1913 (the 1926 index), farm products 40 per cent higher, and other commodities 43 per cent higher.

On this showing the rise in farm products has exceeded that of World War I, the rise in foods has been as great, but the rise in non-farm products is less than half as much. Although in 1939 farm products were too low, the figures nevertheless indicate which commodity groups are now "too high". In terms of 1939 relationships farm products are nearly 70 per cent higher than non-farm prices. They are also the most influential group in the cost of living.

No one has yet suggested any way of bringing farm prices down except through the operation of free markets, and no one need doubt that free market forces in due course will have that effect, for a demonstration has been given in the price declines of the past month. Excessive prices work their own cure. They stimulate production and curtail consumption, and they are working that way now.

Non-farm prices are obviously not too high for farmers to pay, but many are too high for the pocketbooks of the average city buyer. Hence many may be too high to equate supply and demand in the period ahead. Therefore they are vulnerable. Non-farm prices may also be too high if they yield producers a greater profit than is necessary to assure needed production, a fair return, and an adequate flow of new capital into the industry for replacement, modernization, and expansion. This test is one which critics of prices of manufactured goods may justly make, and when profits exceed these requirements they endanger stability. They should be, and are likely to be, corrected by price reductions.

Moreover, it is entirely true that the general interest is served by seeking profits in low margins and high volume rather than in high margins and low volume. The country has applauded the voluntary price cuts of the Ford Motor Co. in January, of the International Harvester Co. in March, and the others since, because everyone instinctively knows that this is the formula for lasting prosperity and progress. Producers of steel, copper, automobiles and other lines have refrained from charging all the market would bear, as shown by the premium prices obtainable when buyers have these things for resale.

Unfortunately many critics do not approach the profit figures with a standard such as we have defined in mind. Rather they compare the totals with some past period, without considering whether profits were adequate in the period chosen and without allowance for such factors as are pointed out in our discussion of first quarter profits on a subsequent page. They overlook particularly the conditions which may make current profit rates quite temporary. They overlook the increased cost of the plant and machinery needed to replace present plant and machinery as it wears out. They overlook the fairness of an increased return to shareholders commen-

surate with the rise in the cost of living. Most of them labor under the belief that profits are hoarded or somehow withdrawn from the income stream, though it is perfectly clear that profits are being spent on widespread programs of expansion and improvement in the industries, which are giving employment to millions and maintaining their purchasing power for consumer goods.

The Level of Costs

The free markets, given time, will correct excesses in non-farm prices but their critics show less disposition to wait than in the case of farm prices. However, programs and pressures for price reduction which ignore costs can accomplish little. They can stimulate distributors to take markdowns on goods, but unless replacements are available to sell at the lower prices there will be no permanent gain. In our last issue we published compilations of percentage of net income to sales of 145 retail and wholesale distributors in 1946. The ratio ranged from a low of 1.6 per cent for food chains to a high of 6 per cent for non-food chains, and averaged 4.5 per cent for the group. This was a good margin (though not as high as in some other years) but it does not leave room for price slashes as general and extensive as the newspapers talk about.

Only through continuous effort to cut costs can lasting progress be made. Of President Truman's recent pleas for lower prices the most notable was his statement to the meeting of the United States Chamber of Commerce, in which he placed stress on careful planning, elimination of wasteful methods and practices, expanding facilities where needed, and increasing productivity.

These are sound recommendations. Against them must be set the fact that another round of wage increases in the pattern of 15c an hour is now in motion. A surprising number of people view the increases with complacence, holding that it is worthwhile to avert major strikes and hoping that out of present profits and a possible increase in man-hour output the higher wage costs can be readily absorbed. But the conflict between wage increases of this size and the plea for lower prices is obvious. In many cases there was doubtless a choice as to which to do, now resolved in favor of the wage worker against the consumer. In few cases is there room to do both.

Some believe the situation is actually strengthened by wage increases on the ground that a desirable expansion of purchasing power will result; and with an eye on the high farm prices some think the wage advances will be beneficial even though prices of some manufactured goods have to be increased. But the state of purchasing power cannot be judged by looking at the farmers and the members of trade unions alone. Together they constitute substantially less than half of the gainfully employed people, and the half which has already enjoyed the greatest increases in income. The other half will now be still further behind the procession. Many of them, such as pensioners and other recipients of fixed incomes, cannot possibly catch up. The railroads, which earned only 2.3 per cent on their net worth in 1946, cannot give wage increases without raising rates. Farmers and factory workers alone cannot buy the full output of the consumer goods industries.

Even more important, the wage increases can be expected as usual to outlast the profit increases, and to stand as an obstacle to cost reduction when lower costs become imperative to keep up sales, production and employment. In numerous cases business already is reaching that position.

The circumstances point to but one conclusion. With wages moving to new highs, lower manufactured goods prices must be sought chiefly through higher production per man-hour and resulting lower unit costs. The responsibility falls on management to squeeze out waste and improve methods and processes, and on labor to give a more efficient day's work. Beyond that there is hope of lower prices for raw materials as supplies catch up with demand. Both management and labor are on notice that they must satisfy markets which in many cases have already changed in favor of the buyer, and which will change in other cases as time goes on. Those who meet this test successfully will be those who find out what the buyer can and will buy, and then find a way to produce it.

Basic Commodities Decline

While the discussion has been at its warmest basic commodity prices have been declining, led by foodstuffs. An index of prices of 12 basic foods compiled daily by the Bureau of Labor Statistics rose 18 per cent between the end of January and the middle of March. It turned down sharply at the beginning of April, and at the end of the month was back to the January level. The price of wheat has dropped 40c from the peak, corn 25c, hogs 8c, lard 10c, butter 16c, cottonseed oil and soy bean oil each 12c, and coffee and cocoa 4½c and 5c, respectively. The index, however, is still roughly 20 per cent above its level last Fall, before the decontrol of livestock and meats, and more than 60 per cent above the level prior to the temporary expiration of OPA on June 30.

Another notable development during the month has been the break of 5 to 7c a yard in spot prices of certain constructions of cotton goods, in which there has been a second-hand market at stiff premiums above mill quotations. This follows a similar drop in rayons and a slump in soft woolens. As usual some people have found themselves with more goods on hand or committed for than they wanted and have offered them for re-sale, while buyers at the same time lowered their ideas. Prices for forward deliveries, which were substantially below the spot market, have held steady. Cotton mills are sold up for the second quarter and have considerable orders on hand for the third and fourth quarters.

In view of the heights which food and clothing prices had reached and their weight in the cost of living, these declines should be a source of gratification. They probably signify that the peak of the food cost of living and of textile prices has been passed. People who can buy these things for a little less will have that much more to spend for other goods.

It is true that now that a price drop has come – the first of any magnitude since 1940 – people are wondering whether it is as beneficial as they had hoped or whether it may not be the beginning of liquidation, losses and depression. Some one experiences losses in every price decline, and a precipitate and disorderly drop which allowed insufficient time to turn around would do severe damage. The drop so far, however, cannot be regarded as of great consequence. The ground retraced has been only that of a seven weeks' rise from late January into March. In that time few buyers can have accumulated high-priced stocks which would leave them vulnerable to severe losses. The general attitude has been one of prudence and conservatism, although risks are unavoidable.

Meanwhile the benefits of the decline, pointed out in discussion in many quarters for months past, are an offset. The prices which have dropped have been out of line with other prices. They are weighty in the cost of living. Their decline improves the balance in price relations, and the realignment has been needed. As to the fear that this may be the beginning of a major retracement of the inflationary rise, there are many factors — including the money supply, the financial liquidity of the economy as a whole and of corporations generally, the undeniable needs for more goods of many kinds here and abroad — which argue against such a retracement. It would be hard to put together even a short list of basic commodities of which prospective supplies can be considered excessive, provided only that demand is not cut off by such exorbitant prices as have been seen in some markets this year.

First Quarter Earnings

Reports now available for 385 companies in the manufacturing, mining, trade, and service industries for the first quarter of 1947 reveal a tendency for earnings generally to level off, following the progressive rise during last year to the high point in the final quarter as a result of the great expansion in volume and rise in commodity prices. Combined net income after taxes was $671 million, compared with $683 million in the last quarter of 1946, a decline of 2 per cent, with nearly half of the number of reporting companies showing decreases. Taking account of the new round of wage increases now going into effect, recent price declines, and the rapid shifting in many lines from sellers' to buyers' markets, there appears to be little doubt but that the peak of business earnings generally was reached in the past two quarters.

Compared with the first quarter a year ago, when production was curtailed by strikes, reconversion, and materials shortages, earnings in the aggregate show a large increase, net after taxes rising from $291 million to $671 million, or by 131 per cent. The gain was heavily affected by the recovery to full-time operation of the durable goods industries, which were particularly hard hit last year by strikes and other production difficulties. Such important companies as American Steel Foundries, Chrysler Corporation, General Electric, Republic Steel, Westinghouse Electric, and Worthington Pump & Machinery reported actual deficits a year ago, while numerous others barely managed to keep out of the red, some only with the help of carryback tax credits. Altogether, 61 companies in the iron and steel, automobile, machinery, and other industries reported a shift from net deficits aggregating $58 million in the first quarter of 1946 to net income of $111 million in the first quarter of 1947.

Many other companies, particularly in the consumers' good industries which were not seriously curtailed a year ago, also reported substantially increased earnings, though here again the gains were by no means uniform. On the other hand, the combined net earnings of 24 merchandising companies, despite an expansion in volume of sales, showed a decline as compared with a year ago, reflecting growing buyer resistance to high prices and the necessity for markdowns in order to move goods. There were also decreases in net income scattered through most of the manufacturing industries. For all groups combined, 71

NET INCOME OF LEADING CORPORATIONS FOR THE FIRST QUARTER

Net Income is Shown as Reported — after Depreciation, Interest, Taxes, and Other Charges and Reserves, but Before Dividends. Net Worth Includes Book Value of Outstanding Preferred and Common Stock and Surplus Account at Beginning of Each Year.

(In Thousands of Dollars)

		Net Income			Net Worth		Annual Rate of Return %		
No. of Cos.	Industrial groups	1st Qr. 1946	4th Qr. 1946	1st Qr. 1947	January 1 1946	1947	1st Qr. 1946	4th Qr. 1946	1st Qr. 1947
21	Food products	$ 22,295	$ 47,555	$ 44,609	$ 714,550	$ 771,799	12.5	26.6	23.1
18	Pulp and paper products	7,895	14,085	22,469	300,914	374,994	10.5	18.7	24.0
38	Chemicals, drugs, etc.	95,611	94,114	100,716	2,024,790	2,208,163	18.9	18.6	18.2
17	Petroleum products	60,464	101,783	93,832	3,174,420	3,391,442	7.6	12.8	11.1
16	Cement, glass and stone	6,448	20,929	22,942	490,216	559,206	5.3	17.1	16.4
29	Iron and steel	17,560	88,007	111,844	3,296,886	3,403,353	2.1	10.7	13.1
11	Electrical equipment and radio	D-34,631	55,708	33,374	759,314	811,176	—	29.3	16.5
29	Machinery	1,787	11,606	12,626	413,532	483,703	1.7	11.2	10.4
26	Autos and equipment	D- 3,311	36,384	49,216	671,736	784,044	—	21.7	25.1
64	Other metal products	18,650	68,886	61,290	1,178,296	1,283,117	6.3	23.4	19.1
53	Miscellaneous mfg.	50,506	84,272	69,031	896,915	1,048,217	22.5	37.6	26.3
322	Total manufacturing	243,274	623,329	621,949	13,921,570	15,119,214	7.0	17.9	16.5
26	Mining and quarrying	13,079*	21,806*	20,862*	569,577	632,411	9.2	16.3	13.2
24	Trade (wholesale and retail)	28,730	30,785	23,438	572,264	700,250	20.1	21.5	13.4
13	Service industries	5,720	6,715	4,626	177,891	188,629	12.9	15.1	9.8
385	Total	$290,808	$682,635	$670,875	$15,241,302	$16,640,504	7.6	17.9	16.1

* Before depletion charges in some cases. D- Deficit.

companies or 18 per cent of the total number made less money in the first quarter of this year than in the same period last year.

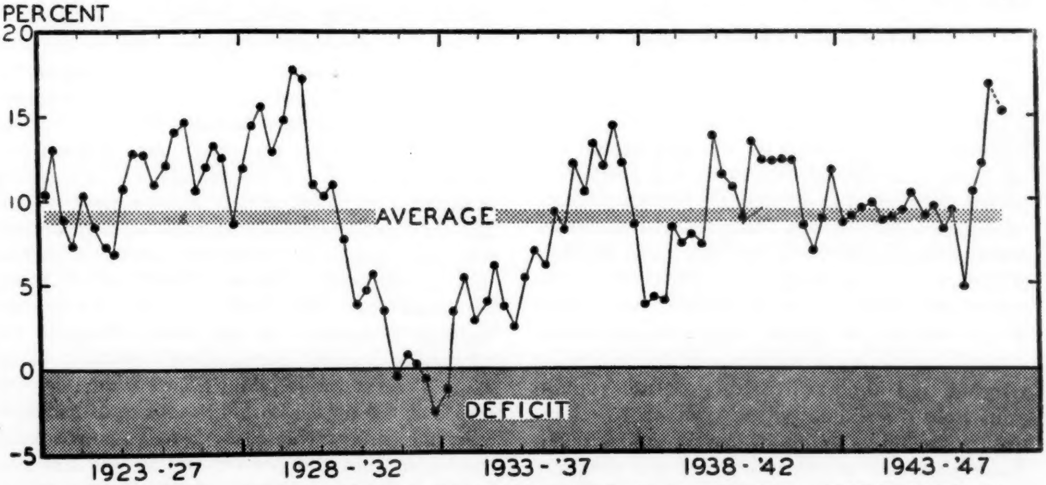
The importance of volume as a factor in determining earnings is suggested by the sales figures reported by 161 manufacturing companies, which increased 64 per cent over a year ago. Sales of 35 companies, chiefly in the steel, electrical equipment, automobile, and other industries that were curtailed last year, more than doubled. Combined sales of the remainder increased by 49 per cent. The merchandising companies that have reported quarterly earnings, comprising only a small fraction of total retail and wholesale trade, had a sales increase of 15 per cent.

Accompanying is our customary tabulation of earnings by business groups, altered in this instance to show not only the comparisons with a year ago, but also the more significant comparisons with the fourth quarter of 1946. Quarterly figures are subject to tax and other adjustments at the year-end.

Long-Term Trend of Earnings

The accompanying diagram showing quarterly earnings of 200 large industrial corporations in terms of annual rates of return on net worth back to 1923, with the first quarter of 1947 partly estimated, provides a long-term perspective for measuring currently reported earnings and brings out a number of points that need taking into account in present discussions of this subject:

(1) That by and large the rate of earnings of leading corporations for the past two quarters was definitely high historically, though no higher



Annual Rate of Return on Net Worth of 200 Large Industrial Corporations by Quarters. First Quarter of 1947 Partly Estimated.

than in 1929 despite a much larger increase in volume than in net worth.

(2) That comparisons of first quarter 1947 earnings with a year ago are with a period of much below average earnings — a fact that must be allowed for in judging the significance of large percentage increases now being announced.

(3) That earnings are highly unstable and subject to wide fluctuations. Just as they advance rapidly in periods of expanding business, so they can fall rapidly in periods of business recession. It is worth pondering by investors, business management, and labor alike that not in the entire period of 24 years covered in the diagram has business enjoyed more than two consecutive quarters of such high earnings as have been recorded in the past two quarters.

(4) Bearing further on (3), the danger of making every earnings increase a basis for commensurate wage demands should be patent to all. Apart from any question of equity or of the economic effect of according to labor a monopoly interest in any increased industrial earning power, is the fact that wage rates, once advanced, are not readily reduced, while profits, on the other hand, can easily be up one year and down the next. This makes all the difference in the world in comparing wage rates and profits. If wage rates are advanced too fast on the basis of temporary bulges in profits, two things happen: (a) in any decline in operations the point at which concerns start running into the red and are forced to curtail production comes all the quicker, with the result that, while wage rates may hold, workers lose earnings through loss of jobs, and (b) there is a great stimulus to use of labor-saving devices which displace workers and likewise mean loss of jobs.

Effects of Price Changes

An additional factor in the earnings picture is the effect of the sharp advance in commodity prices upon current earnings, and also upon the companies' requirements for working capital and for plant and equipment. In such a period, reported earnings are inflated by inventory gains which are non-recurrent, and may turn into losses when prices decline, and are expressed in terms of dollars of diminishing purchasing power. More dollars are needed to carry on the same volume of business and to replace worn-out fixed assets.

Rising prices tend to cause wider operating margins, and almost invariably create windfall gains from the selling out of low-cost inventory, and rise in the valuation of inventories on hand. These gains can be misleading in that a company continuing in business must invest such profits in new inventories at the higher prevailing prices. In this respect a corporation is in the same position as an individual who sells a house costing $6,000 for $12,000 but then, after paying a tax on his $6,000 "profit", is forced to turn around and buy another house at an inflated price.

Such overstatement of current "earnings", and exposure to subsequent loss, may be reduced or eliminated by the use of the LIFO (last-in, first-out) method of accounting, or by setting aside from earnings an inventory reserve. Under the LIFO method, designed to eliminate the effect of price fluctuations upon earnings, and accepted by the Treasury Department for tax purposes in 1939, the cost of current sales is matched against cost of current purchases, so that book valuation of the same inventory on hand does not increase despite a rise in prices.

An increasing number of companies have obtained permission from the Commissioner of Internal Revenue to adopt this method for tax returns, and of the 100 largest American manufacturing corporations, based upon volume of sales last year, 36, representing 38 per cent of the total sales of the group, use LIFO in whole or in part. The remaining 64 value inventories on the general basis of "cost or market whichever lower", with various modifications and with special inventory reserves in a number of cases.

Nevertheless, in spite of conservative accounting generally, the heads of many companies have called attention to the fact that valuation methods did not in all cases prevent price advances from showing up in what is in effect inventory appreciation. This is especially true where inventories have been depleted to such a point that low-cost materials have been sold in finished form at the prevailing higher prices.

Another consideration during a period of rising prices is the adequacy of reserves charged for depreciation of plant and equipment. Inasmuch as these charges are usually based, for both accounting and tax purposes, upon original cost and expected life, a substantial rise in building and machinery costs means that the eventual outlay for replacement will exceed the depreciation charged against the worn-out assets, as well as the corresponding reserve fund which many companies set aside in the form of cash or marketable securities. At the Socony-Vacuum Oil Company annual shareholders' meeting, President B. Brewster Jennings pointed out that "because of the higher costs of labor and materials, new plants require at least one-half again as much capital as they did prewar and so will continue to draw heavily on the company's resources."

In short, the rise in prices affects not only the value of the wage dollar, but also the corporate income dollar and the dividend dollar. Many of the country's strongest and most successful enterprises have had to borrow heavily during the past year to finance improvements, and for additional working capital to carry inventories and receivables at the prevailing high volume and price level.

As for the shareholders, while total dividend payments increased between 1939 and 1946 from \$3.8 billion to \$5.1 billion, or 34 per cent, according to the Department of Commerce, the cost of living, on the basis of Bureau of Labor annual averages, rose by 40 per cent, so that total purchasing power of these dividends actually declined. By contrast, total wage and salary payments (of which an estimated four-fifths is paid by corporations) increased during the same period from \$44.2 billion to \$106.6 billion, or 141 per cent, and their total purchasing power by 72 per cent.

The Canadian Dollar

The Canadian exchange position has been a subject of increasing inquiry in this country in recent weeks. The discount at which the unofficial or "free" Canadian dollar has been selling under the "official" dollar (which was raised last July to parity with the American dollar) widened during April to over 10 per cent. At the same time it has become generally known that substantial inroads were being made into Canada's U. S. dollar resources. In the public mind these two developments naturally have become associated. There have even been rumors that a new devaluation of the Canadian dollar may be impending. The subject is one of obvious concern in the United States, for Canada is by far the largest buyer of American goods and about \$5 billion of American funds are invested there, including some \$800 million placed in Canadian securities and direct investments during the war.

What is the "Free" Market?

The first point on which people who are interested in the Canadian dollar should have a clear understanding is that the discount currently quoted applies only in the unofficial or "free" market for Canadian funds, and that this market is a relatively narrow one. It exists because Canadian dollars owned under certain circumstances or derived from certain kinds of transactions cannot be converted under Canadian regulations into U. S. funds through official channels at the official rate. However, they can be sold and bought by non-residents. In essence the market is one in which one non-resident may take over another's holdings of inconvertible funds. The total of the funds thus dealt in is seldom large, and small offerings or bids may sway the price considerably. As for the part the unofficial market plays in total transactions in Canadian dollars, it has been estimated that it accounted for only about 3 per cent of Canada's international transactions during the past three years.

The supply of Canadian dollars in the unofficial market comes from (1) bank balances held by non-residents of Canada at the time when foreign exchange control was introduced in September 1939, (2) sales of Canadian securities bought for cash since 1940 and registered with the Foreign Exchange Control Board, (3) sales of Canadian real estate, (4) liquidation of American direct investments, and (5) proceeds from maturing securities payable in Canadian funds.

Canadian dollars acquired through the unofficial market – usually through the intermediary of an American bank – may be used in Canada only for specified transactions. These include (1) purchase of Canadian securities, (2) purchase of Canadian real estate, (3) making loans and direct investments in Canadian businesses. They may also be used by tourists.

These limited-purpose or "inconvertible" dollars therefore cannot be used to pay for exports from Canada. Canadian exporters are required to obtain payment in U. S. dollars which must be turned over to the Foreign Exchange Control Board. Similarly, Canadian residents must surrender to the Board all U. S. dollars received from services of all types and from investments in the United States obtained either as income or through the sale of securities.

On the other hand, the Exchange Board provides dollars at official rates out of official reserves for all current transactions. Hence Canadian dollar interest or dividend checks will, if presented to a Canadian bank by a non-resident, be converted into U. S. dollars at par. Certain capital payments, such as payment for bond issues payable in U. S. dollars, are also made at par out of official reserves.

From 1943 to the middle of 1946, the demand for inconvertible Canadian dollars by non-residents was large enough to maintain the free market rate close to the official rate. Following the up-valuation of the dollar last July, however, the supply exceeded the demand, largely because of repatriation of U. S. capital invested in Canadian securities. This repatriation may have been induced first by profit taking, and probably has been speeded up in the past few months by con-

cern about Canada's loss of U. S. dollars. There would seem to be a strong possibility that demand for inconvertible dollars will improve once the tourist season opens, for the present discount and the relatively low level of prices in Canada combine to make vacation trips by Americans attractive. Moreover, the discount is an inducement to Americans to make capital investments in Canada.

Canada's International Payments

The inroads into Canada's U. S. dollar reserves are occurring despite the fact that her over-all current account transactions are showing a record peacetime surplus. The official gold and U. S. dollar resources, reported at $1,508 million at the end of 1945, declined to $1,245 million by the end of 1946. The explanation lies in the fact that Canada's deficit in her balance of payments with the United States must be met out of her own U. S. dollar resources, while Canada's surpluses in her balance of payments with other countries up to now have been largely financed on credit, or are in funds not yet convertible into U. S. dollars.

Last year, with a high level of employment and income, and with many war-deferred purchases of industrial equipment and raw materials made here, Canadian expenditures in the U. S. were of record proportions. In the closing months of the year, Canada's imports from the United States reached an annual rate of $1,800 million, reflecting in part the rise of prices here.

The table below shows Canada's current transactions with the United States and the sources from which the deficit of $603 million was financed. Interest and dividend payments were the largest since 1940, due to heavy dividends paid by Canadian subsidiaries of American enterprises. Record American tourist expenditures of $214 million were reduced by Canadian travel expenditures here which also reached a new peak of $131 million. Shipments of the newly mined gold fell considerably below prewar. But the output of the gold mines is rising despite the shortage of labor and the lower price of gold.

Canada's Current Transactions with U. S. in 1946
(In Millions of Canadian Dollars)

Canadian Payments to U. S.	
For imports from U. S. (a)	$1,878
Interest and dividends (net)	204
Freight and shipping (net)	66
Others incl. purchase of U. S. fixed assets (net)	82
Total Payments	$1,730
Canadian Receipts from U. S.	
For exports to U. S. (a)	948
Shipment of non-monetary gold	96
Tourist and travel (net)	83
	$1,127
Balance in U. S. favor	603
Settled as follows:	
Draft on Canadian gold and dollar reserves	263
Surrender of gold purchased in U. K.	150
Transfer of $ credits from other countries	87
Capital inflow and exchange adjustments	103

(a) Adjusted figures. Source: Annual Report of the Canadian Foreign Exchange Control Board.

Canada's Sterling Balances

While the deficit in Canada's 1946 transactions with us aggregated $603 million, she had on the other hand a credit of $954 million (without counting $102 million for Mutual Aid and official relief) in her current transactions with Great Britain and other countries. There would have been no strain in Canada's current balance of payments with the United States, and hence no question about the soundness of the Canadian dollar had all the customers of the Dominion been able to pay her in freely convertible currencies. Unlike the French franc and other Continental currencies that are under pressure because of internal complications, the pressure on the Canadian dollar stems entirely from the fact that multilateral trading and currency convertibility have not yet been sufficiently restored.

Canada's economic position probably has never been stronger. Not only did she escape wartime destruction, but there was a great expansion and diversification of productive capacity. The number of employes in manufacturing industries has nearly doubled since prewar. Moreover, the Dominion has handled her postwar transition problems as well as any country. Her cost and price structure has remained considerably below that of the United States. As a result, Canadian products in world markets are in an improved competitive position.

But the final solution of Canada's exchange problem is tied up with the extension of multilateral trading and worldwide currency convertibility. The decision of the British authorities last January making the net balance of sterling earned by Canada (and a number of other countries) on current transactions freely convertible into U. S. dollars, was a step in the right direction.

International Fund and Bank

The two new ventures in international financial collaboration, the World Fund and Bank, with combined resources calculated at $15½ billion, have now reached the stage of active operation although no loans have been announced.

The top management of the International Bank for Reconstruction and Development has been reconstituted following the resignation in December of Eugene Meyer as President and the late Harold D. Smith as Vice-President. The Bank is carrying forward plans for its first loans

and last month opened a New York office to direct the distribution of forthcoming public offerings of debenture bonds.

The International Monetary Fund approved exchange rates for thirty-two countries in December, received "quota" contributions from members in February, and officially declared itself ready to begin transactions on March 1.

The membership of both institutions has risen to 44 with the addition of Venezuela, Turkey, Italy, Syria, and Lebanon. Of the countries represented at the Bretton Woods Conference, the U.S.S.R., Australia, New Zealand, Haiti and Liberia have not accepted membership, although Australia is reconsidering her earlier decision not to participate. Other non-participants include Argentina, Finland, Portugal, Sweden and Switzerland, which were not represented at Bretton Woods, as well as the countries with which we are nominally still at war.

Coming Test of Creditworthiness

The International Bank, in getting under way, faces the immediate task of winning investor confidence and gaining a market for its securities; for the bulk of the money which is to be lent must first be obtained by borrowing through the sale of Bank obligations to the public. A step toward opening a substantial market for World Bank debentures was realized early in April when Governor Dewey approved a bill authorizing New York State insurance companies to invest up to 5 per cent of their total admitted assets in securities issued or guaranteed by the Bank. Similar action in respect to New York State savings banks was taken last year and has been taken in certain other States in respect to either insurance companies or savings banks. In some States no special legislative authorization will be required for these classes of investors.

Purchases by member banks of the Federal Reserve System, up to the limit of 10 per cent of capital and surplus, apparently will require only a ruling by the Comptroller of the Currency that International Bank obligations are "investment securities." Nonmember state banks, large in number but relatively small in resources, are subject to various state laws.

But more than legislative permission to buy is necessary to the development of a broad market for World Bank obligations. Potential investors generally are waiting to see the amounts and kinds of credits the Bank extends and the conditions attached for the protection of the Bank and its security-holders. Basic loan policies will go far to decide the intrinsic quality of the securities which the Bank sells and the demands for them.

To a greater extent than was apparent even six months ago, the Bank will have to rely on the American market to raise money for its lending. While gold and dollar assets held by foreigners still run much larger in the aggregate than before the war, they are far from evenly distributed and some individual countries stand in urgent need of credits of the type which the World Bank was organized to handle. Loan applications have been received from Chile, Czechoslovakia, Denmark, France, Iran, Luxembourg, Mexico, Netherlands, and Poland for an aggregate amount of $2,553,-875,000. While some of the requests have not been fully documented, the needs are mainly for financing purchase of electric generating equipment, locomotives, trucks, tractors, farm implements, industrial machinery, and other materials for reconstruction and development.

The Bank's balance sheet for December 31, 1946 showed that it then held $402,000,000 in dollars. To this amount $158,750,000 was added February 25 by a further United States payment against its $3,175,000,000 subscription, and another $158,750,000 will be received May 26 when the United States, and most other members, are scheduled to complete their contributions of paid-in capital. The Bank thus will have over $700,000,000 working assets in dollars and from this amount some dollar advances can be made to borrowers before funds from the sale of debentures are actually in hand. The Bank's holdings of sterling (£58,000,000), and other currencies that may be required by borrowers, may be adequate for some time to come without the necessity of debenture sales in foreign markets.

To offer debentures to the American public, or for that matter to lend the dollars contributed by the United States, the Bank must first obtain approval from the President of the United States acting on the advice of a National Advisory Council composed of the Secretary of the Treasury, the Secretary of State, the Secretary of Commerce, the chairman of the Federal Reserve Board, and the chairman of the Export-Import Bank. This, in effect, provides a veto power by the American Government over loans made in U. S. dollars.

Protection for the Investor

The first line of protection for the investor in Bank obligations is the reasonable expectation that the borrower will be able to fulfill his contractual obligation to the Bank. This it will be the responsibility of the directing heads of the Bank to assure, through careful analysis of loan

applications, avoidance of excessive risks, continuous observation of the uses made of loans, and keeping a weather eye for emerging weaknesses. The official staff which shoulders this large responsibility, as reconstituted, is stronger than ever in terms of men of recognized ability and tested experience.

The second line of protection is the ability of the member Governments to make good on their commitments to reimburse the Bank for losses suffered through defaults of borrowers. The amount for which each Government is liable is limited by the amount of its subscription to capital. The United States, for example, which on May 26 will have paid in $635,000,000 (20 per cent of its subscription), is liable to the extent of an additional $2,540,000,000.

American investors will tend to consider themselves fairly protected on this second line of defense so long as the Bank's loans do not exceed the contributions made or on call from member countries whose international accounts and finances are reasonably well ordered, and which have good records of fulfilling international financial obligations. Beyond about the $4 billion mark, the Bank debentures would have to rely for this secondary protection on the ability of weaker members to carry through on their guarantees. Here, in light of manifest financial difficulties in so many countries and past records, there are some not unnatural doubts.

On the other hand, the Bank may find, with the numerous intergovernment credits and the availability of private credits to top-grade borrowers such as Australia and Norway, that the scope for International Bank credits may not extend beyond $3 or $4 billion. The Bank is designed to handle borderline cases, good but not good enough to borrow in the open market for all their needs. As world conditions improve the number of these cases should lessen. Moreover, the rate at which credit lines can be used will be subject to definite physical limitations on exportable supplies. It may well prove most practicable, in any event, for the Bank to proceed with the larger credit applications in stages, so as to judge the progress of reconstruction programs before becoming too deeply committed.

The Interwar Foreign Lending Experience

A survey of the experience of American private investors in foreign bonds sold during the interwar period, based mainly on U. S. Department of Commerce compilations, discloses that Americans invested about $8½ billion in foreign bonds between 1920 and 1940 and that roughly one-third of these went into default with the onslaught of the world depression in the 'thirties. In 1940 losses of principal, including losses from market depreciation, stood at $3½ billion according to Commerce Department estimates. The war, moreover, led to some additional defaults by countries which previously had maintained their payments. Nevertheless, the record was less black than often is realized.

How would the International Bank have borne up under those conditions if all the loans had been made by that institution? The estimated $3½ billion loss of principal would have been about 45 per cent of the present subscribed capital of the Bank. This 45 per cent is about equal to the combined United States and Canadian subscriptions.

It would be unwise to attach undue weight to this sort of hypothetical calculation. Rates of interest were high during the nineteen-twenties, affording the investor a compensation for risk. On the other hand, the Bank, while it doubtless will offer lower rates on its debentures, will be required to accumulate a guarantee fund from charges on borrowers so as to build up a special reserve against the contingency of defaults. The statutes of the Bank also require an investigation of the economic position of borrowers and their power to repay under which some of the loans of the '20s would hardly have qualified.

Fund Approves Currency Values

In announcing last December that it would begin transactions on March 1, the International Monetary Fund accepted proposed currency values for 32 countries. In the case of Brazil, China, Greece, Poland, Uruguay, Yugoslavia and three minor currencies, action was held in abeyance by request of the concerned governments.

Many observers were surprised by the acceptance of existing currency values for all 32 currencies on which action was taken. There had been no disposition to question acceptance of the valuation of the U. S. dollar and the British pound, which provide units of measure for other currencies; but with the disorganization of industry, commerce, and finance in so many member countries, and their unequal multiples of inflation, it was expected that the Fund's studies might lead to some revisions of currency values based upon substantial disparities in price and wage levels among other countries.

The Fund, however, in a newspaper release explaining its action, emphasized that it was "not to be interpreted as a guarantee by the Fund that all the rates will remain unchanged":

The Fund realizes that at the present exchange rates there are substantial disparities in price and wage levels among a number of countries. In present circumstances, however, such disparities do not have the same significance as in normal times. For practically all countries, exports are being limited mainly by difficulties of production or transport, and the wide gaps which exist in some countries between the cost of needed imports and the proceeds of exports would not be appreciably narrowed by changes in their currency parities. In addition, many countries have just begun to recover from the disruption of war, and efforts to restore the productivity of their economies may be expected gradually to bring their cost structures into line with those of other countries. Furthermore, for many countries now concerned with combating inflation there is a danger that a change in the exchange rate would aggravate the internal tendencies toward inflation.

One curious sidelight on exchange rates is the sluggishness of countries to adjust downwards rates that, beyond doubt, are too high. At Bretton Woods and in the later discussions there was widespread apprehension that a wave of competitive currency depreciation would set in after the war. On the contrary there is some present reason for concern that overvalued currencies will be kept overvalued and defended by various devices of the 'thirties, exchange controls, import quotas, foreign trade monopolies, and prohibitive tariffs, which suppress or distort international trade to the ultimate disadvantage of everyone. These restraints are now under study by representatives of 19 countries meeting in Geneva.

Use of Fund's Resources

In announcing its acceptance of exchange rates the Fund deferred the date for beginning actual operations for two and a half months, until March 1. Here there were some apprehensions that many member countries would immediately rush in to borrow the annual amount to which, on the literal reading of the statutes, they would seem "entitled." On this point, however, statements of policy by Camille Gutt, managing director, have been strong and positive. He has said that the Fund will advance dollar exchange only "where there is every reason to believe that the loans can be repaid by the operations in sight." The Fund "will turn down applications from Governments which seem to be dissipating their resources or to be operating on a poor economic basis." That the Fund regards itself as having a choice, and as not being under compulsion to lend, brightens very much the outlook for its future.

As time goes on an interpretation of the Fund's statutes, agreed to by its Executive Directors last September, promises to grow in importance. Insisted upon by Representative Jesse P. Wolcott of the House Banking and Currency Committee at the time the Bretton Woods legislation was before Congress, this interpretation confirmed beyond doubt the prohibition on the use of the Fund to finance relief, reconstruction, armaments, or sustained capital outflows, and pinned down its proper use to providing "*temporary* assistance in financing balance of payments deficits on current account for monetary stabilization operations." Prior to this interpretation the provisions of the statutes were ambiguous enough to leave open the danger that a country might borrow more and more, year after year, until its quota was exhausted, with no predetermined date when repayment would be due.

The League of Nations' Experience

The contribution which the Bretton Woods institutions can make to getting the world economy back on its feet does not lie in the field of financial philanthropy. Money is needed, but it is needed to implement well conceived plans of productive and financial rehabilitation, and not to go down the drain of improvident spending or to postpone a day of reckoning.

After World War I two types of loans were especially effective: the Central Bank Stabilization Loans and the League of Nations Loans. The reason for their effectiveness was that they were each preceded by a thorough review of the position and program of the borrowing country, and at certain times and places loans were accompanied by expert aid and supervision. In this way the granting of the credit became an assurance to the world that an effective economic program was being put into effect.

These loans provide prototypes for World Bank loans. They also must be made with such care and thoroughness of review of a country's economic program that they will constitute an assurance of economic progress.

In addition there will have to be some stop gap loans — or gifts — directly by our Government. Experience suggests that the fewer there are of these the better. Just as a loan from the World Bank will be a hallmark of progress, so the need for stop gap loans is a confession of weakness for the borrowing country.

U.S.A.